RECEIVED

JUL 17 1998

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Before the
FEDERAL COMMUNICATION COMMISSION
Washington, D.C. 20534

In the Matters of	)	
	)	
1998 Biennial Regulatory Review--	)	CC Docket No. 98-81
Review of Accounting and Cost	)	
Allocation Requirements	)	
	)	
United States Telephone Association	)	ASD File No. 98-64
Petition for Rulemaking	)	

COMMENTS OF AMERITECH

Leander R. Valent
Counsel for Ameritech
9525 West Bryn Mawr, Suite 600
Rosemont, IL 60018

Dated: July 17, 1998

TABLE OF CONTENTS

Before the
FEDERAL COMMUNICATION COMMISSION
Washington, D.C. 20534

In the Matters of	)	
	)	
1998 Biennial Regulatory Review-- Review of Accounting and Cost Allocation Requirements	)	CC Docket No. 98-81
	)	
United States Telephone Association Petition for Rulemaking	)	ASD File No. 98-64

COMMENTS OF AMERITECH

I. INTRODUCTION AND SUMMARY.

The Commission initiated this proceeding pursuant to its statutory mandate to review any regulations applicable to providers of telecommunications services and to "repeal or modify any regulation it determines to be no longer necessary in the public interest."[1] The Commission's Notice, however, reveals only a modest review of the accounting and cost rules, and proposes few modifications, while most of the accounting and cost allocation rules are not addressed. In addition, most of the proposed modifications apply only to mid-sized carriers. Ameritech[2] submits that the continued applicability of the Commission's accounting and cost allocation rules to the large ILECs and GTE is not justified, and the Commission needs to eliminate, or at least streamline, the rules in this proceeding.

---

[1] See *In the Matter of 1998 Biennial Regulatory Review - Review of Accounting and Cost Allocation Requirements*, Notice of Proposed Rulemaking, CC Docket No. 98-81, ASD File No. 98-64, Released June 17, 1998, at Paragraph 1 ("the Notice").

[2] Ameritech means: Illinois Bell Telephone Company, Indiana Bell Telephone Company, Incorporated, Michigan Bell Telephone Company, The Ohio Bell Telephone Company and Wisconsin Bell, Inc.

The Commission has received significant input on which to base this Notice, including responses to its Notice for suggestions on forbearance in May of 1996, and requests for ideas associated with its Biennial Review earlier this year.[3] The proposals in the Notice do not reflect that input and simply do not satisfy the requirements of Section 11 of the Communications Act of 1934, as amended (the "Act").

As an initial matter, the Notice requests comments on whether the Class A account structure should be relaxed for the large incumbent LECs and whether there are other accounts or filing requirements that could be reduced or eliminated.[4] Ameritech responds in a resounding affirmative as detailed in the following comments. Ameritech and others have engaged Arthur Andersen LLP to identify opportunities for simplification of the Commission's accounting rules.[5] The Arthur Andersen paper demonstrates that the Uniform System of Accounts (USOA) is archaic, costly, and out of step with the regulatory and competitive paradigm that exists today and proposes specific changes in the accounting and affiliate transaction rules that should be adopted now. Ameritech fully supports the Arthur Andersen proposals and urges the Commission to

---

[3] See Public Notice released May 17, 1996, DA 96-798, IAD 96-150, *Common Carrier Bureau Seeks Suggestions on Forbearance* and responses including that of Mr. Edward J. Marsh of Ameritech to Mr. Peyton Wynns of June 24, 1996, Ms. Mary McDermott of USTA of June 24, 1998, Ms. Nancy Wolf of Pacific Telesis of June 21, 1996, Mr. Robert B. McKenna of USWest of June 24, 1996, Mr. G.R. Evans of NYNEX of June 24, 1996; See also *General Action, Report No. GN 98-1*, released February 5, 1998 initiating the Biennial Review and responses including that of Ms. Robin Gleason of Ameritech of March 13, 1998 to Kenneth P. Moran, Ms. Jeannie Fry of SBC to Mr. Moran of April 7, 1998, Mr. Robert Blau of BellSouth to Mr. Metzger of March 13, 1998, Mr. Gerald Asch of Bell Atlantic of March 12, 1998, The United States Telephone Association (USTA) of February 19, 1998; See also *Petition for Section 11 Biennial Review of SBC Communications, Inc.* of May 8, 1998.

[4] Notice at 6 and 12.

[5] See Attachment 1, Ex Parte filed July 15, 1998, "Accounting Simplification In The Telecommunications Industry", Prepared by Arthur Andersen LLP, July, 1998, (the "Arthur Andersen Paper").

adopt its recommendations as part of this proceeding. Such changes include the following:

- Adoption of Class B Accounting for all carriers.
- Reduction of the continuing property record requirements (CPR).
- Elimination of the expense matrix categorization.
- Reliance on the principles of GAAP materiality standards for expense limits.
- Elimination of Commission notification requirements for the adoption of new accounting standards, recognition of extraordinary items, prior period adjustments and contingencies.
- Elimination of the asymmetrical affiliate transaction rules.
- The adoption of a materiality-based and/or rotational requirement for fair market value studies.
- Expansion of the exemption for conducting fair market value studies and using the fully distributed cost valuation standard for support services provided to affiliates.

Similarly, Ameritech supports the proposals of the United States Telephone Association (USTA) for specific rule changes to the USOA and cost allocation requirements. As an absolute minimum, and only as an interim step in the event the Commission decides to retain the Class A account structure for the large ILECs and GTE, Ameritech proposes that unnecessary detail, notification requirements, and constraints associated with the Class A account structure be modified consistent with the statutory mandate of Section 11 of the Act. Ameritech's proposals were initially outlined in the letter from Ms. Robin Gleason, Director - Regulatory Finance to Mr. Kenneth P. Moran dated March 13, 1998 (the "Ameritech Accounting Reform Proposal").[6] Ameritech is attaching a complete annotated USOA based on its initial proposals.[7]

---

[6] See Attachment 2.

[7] See Attachment 3.

II. THERE IS NO VALID JUSTIFICATION FOR RETAINING CLASS A ACCOUNTING REQUIREMENTS FOR THE LARGEST INCUMBENT LECS.

The Notice proposes to modify the dollar threshold for the applicability of using the Class A account structure of the USOA, specifically in order to relieve the mid-sized LECs from providing the Class A level of detail, while continuing the requirement for the large ILECs and GTE.[8] The Notice attempts to justify the retention of Class A accounting for the large ILECs and GTE, claiming (i) greater Commission monitoring and oversight of the large incumbent LECs is necessary because of the higher volume of transactions involving competitive products (ii) the Class A level of detail is necessary to uphold the obligations under §§ 254(k), 260, 271, 272, 273, 274, 275, and 276 (iii) the identification of potential cost misallocations because of more refined cost allocations and (iv) as incumbent LECs maintain more detail than required under Class A accounting, the burden imposed does not outweigh the Commission needs for collecting financial information.[9] Each justification is unconvincing and discussed in turn.

With respect to the supposed higher volume of transactions of the large incumbent LECs, a more appropriate comparison should be based upon a relationship of dollar value of affiliate transactions to total operations. A comparison, based upon dollar value of transactions as opposed to volumes, of the large ILECs/GTE with mid-sized LECs (see Table 1) demonstrates that the overall level of affiliate transactions is very small in both groups and relatively there is

[8] Notice at ¶4.

[9] Notice at ¶¶5-6.

very little difference between the two groups.[10] While Ameritech is supportive of the relief proposed by the Notice for all carriers,[11] transaction volume does not justify the continuation of Class A accounting for the larger LEC group. In fact, the mid-sized LECs have a higher dollar value of affiliate transactions to their total operations in their use of tariff, prevailing price, and FDC transactions than the large ILECs, suggesting the opposite of the Notice's justification.

Table 1
Purchases from Affiliates

	Assets	Tariff	Services Prevailing Price	FDC
Large ILECs/GTE	0.4498%	0.0417%	0.2381%	11.7230%
Mid-LECs	0.2563%	0.3319%	3.0402%	16.3106%

Sales to Affiliates

	Assets	Tariff	Services Prevailing Price	FDC
Large ILECs/GTE	0.2989%	0.4264%	0.0725%	2.1215%
Mid-LECs	0.0863%	1.9659%	0.5379%	4.4696%

Regarding the Notice's second justification, the need to uphold the Commission's obligations under the Act, the Arthur Andersen paper demonstrates there is no basis for the

[10] Information was compiled using available information from FCC ARMIS 43-02 reports for 1997 (excluding Bell Atlantic information which was not accessible). Percentages were developed taking the sum of the results for each company in the peer group for the identified transactions. For asset purchases and sales, the sum was divided by the peer group's total plant in-service. For purchases and sales of services, the tariffed and prevailing price transactions were divided by the peer group's total revenue, while the transactions at fully distributed cost (FDC) were compared to the peer group's total operating expenses.

[11] See Comments of Ameritech, *In the Matter of Petition for Forbearance for 2 % Mid-Size Local Exchange Companies*, File No. AAD 98-43 of May 4, 1998, wherein Ameritech supported relief for mid-sized LECs and urged similar relief for all carriers because selective forbearance is inconsistent with the Commission's deregulation and streamlining policies and promoting competition.

continued application of Class A accounting for the large incumbent LECs.[12] Furthermore, the Notice has failed to show why it is necessary to report balances at the Class A level to monitor competition. In fact, the Commission has failed to show how reporting at either the Class A or Class B level can yield any indication of the level of competition. Rather than continuing detailed reporting requirements, the Commission should streamline and/or eliminate regulatory reporting detail, especially as it applies to only a subset of a segment of an industry.

Furthermore, the Act's prohibitions against cross-subsidy and its separate affiliate requirements and other accounting requirements, such as requiring separate books of account, do not require a Class A level of accounting for incumbent local exchange carriers. These accounting requirements in Sections 271, 272, 273, and 274 of the Act are obligations of the separate affiliate. For Sections 260 and 275, where the separate subsidiary is not a requirement of the Act, the cost allocation rules at a Class B level are sufficient to meet the Commission's statutory obligations. The Notice's assertion that Class A accounting is "necessary" to uphold such statutory obligations is simply not supported by any language in the Act. Section 254(k) compliance, for example, is not limited to the largest incumbent LECs. Rather, it applies to all telecommunications carriers including CLECs for which Part 32 does not even apply. Additionally, historic data available from Class A accounting is not used for establishing costs of universal service. The Commission's Order on universal service requires the use of forward

[12] Arthur Andersen Paper at 11-13.

looking economic costs, which neither depends on nor uses Class A historical accounting data.[13] Logically then, if Class A accounting detail is not necessary to ensure Section 254(k) compliance for some carriers, then it is not necessary for ensuring Section 254(k) compliance for any carrier.

With respect to the third justification, the identification of potential cost misallocations, the Notice asserts that a Class A level of accounting detail is necessary because the cost allocations are more refined. Detail for the sake of detail is scant justification for continuing a Class A account level. As demonstrated on Attachment 4, the Commission's cost allocation rules, pursuant to Section 64.901, which require the maximization of direct assignment to regulated and nonregulated activities, are not compromised by using a Class B account structure because any costs that could be directly assigned using Class A detail would continue to be directly assigned, consistent with the cost allocation rules. Use of Class B for cost allocations simply reduces the administrative requirements. As shown on Attachment 4, using Class B for Account 2110, Land and Support Assets, reduces the number of cost pools from 40 under Class A to 22 under Class B, with no rule changes to the Commission's cost allocation rules. The identification of any potential cost misallocations are assured at the Class B level of detail and would assure uniformity of cost allocations for all subject carriers consistent with the Commission's goal of uniformity.[14]

With respect to the justification based on large incumbent LECs maintaining a greater level of detail than required under Class A accounting, the Notice minimizes the burden of Class

---

[13] See *In the Matter of Federal-State Joint Board on Universal Service*, Report and Order, CC Docket No. 96-45, released May 8, 1997, at ¶227, "Thus, for the reasons articulated by the Joint Board, we conclude that the universal service support mechanisms should be based on forward looking economic cost, and we reject the arguments for basing the support mechanisms on a carrier's embedded cost." See also, ¶251 which describes the criteria for forward looking economic cost determinations, none of which require a Class A level of accounting detail.

[14] See *In the Matter of Implementation of Further Cost Allocation Uniformity*, AAD 92-42, released July 1, 1993 See also, Arthur Andersen Paper at 23.

A accounting. The Notice misses the point for several reasons as demonstrated in the Arthur Andersen paper. First, the USOA, which was designed and adopted under traditional rate of return regulation, has evolved into a system that has no practical purpose because all large incumbent LECs are under a no-sharing price cap system in the federal jurisdiction and most companies are under alternative regulation with no cap on earnings in the state jurisdictions. Second, the USOA is not used by management to run the business nor by the financial community to assess the success of the business. Companies are constrained from adopting state of the art general ledger and reporting systems because of the need to factor in or modify such systems in order to accommodate the archaic and unnecessary regulatory reporting requirements of the USOA. Third, as an accounting system, the USOA does not further the goal of reporting the results of operations in a consistent and relevant manner. All ILECs should be subject to the same requirements as their competitors under Generally Accepted Accounting Principles (GAAP).

The Notice asks for comment on the possible effects that moving to Class B accounting for mid-sized carriers will have on the jurisdictional separations process.[15] The answer is obvious since the jurisdictional separations process uses Class B accounting for all carriers, there will be no effect and therefore Class B accounting is appropriate for all carriers.[16]

Indeed, Class B account structure for all carriers is fully consistent with the basis for the USOA. Section 32.2(f) states in pertinent part that the USOA, ". . .will provide the information necessary to support separations, cost of service and management reporting requirements." Since

---

[15] See Notice at ¶5.

[16] See *In the Matter of MTS and WATS Market Structure, Amendments of Part 67 (New Part 36) of the Commission's Rules and Establishment of a Federal-State Joint Board,* CC Docket Nos. 78-72, 80-286 and 86-297, Report and Order, released May 1, 1987, at paragraph 17, "We also adopt the Joint Board's recommendation in Docket 86-297 that a modified version of the (Separations) Manual that was proposed for Class B carriers be used by all carriers." See also, Arthur Andersen Paper at 23.

jurisdictional separations uses a Class B level for all carriers, the large incumbent LECs are under no-sharing price caps with no need for the detailed Class A level to support cost of service, and since management does not use the USOA for reporting requirements, adoption of Class B for all carriers is consistent with the Commission's stated purpose for the USOA.

The Notice requests comment on the need for mid-sized carriers to maintain subsidiary record categories (SRC) at the Class A level in order to provide the necessary information for pole attachment formulas.[17] There may be a continuing need for all carriers to provide this particular information at a Class A level. However, this should not prevent the Commission from allowing large ILECs to provide the same SRC information while under a Class B account structure.

The Notice maintains that the Class A account structure is necessary for the Commission's monitoring and oversight efforts, describing an audit of lobbying activities for the period 1989 through 1991.[18] Class B accounting would not compromise the Commission's monitoring and oversight efforts. First, the large incumbent LECs are under no-sharing price cap regulation. Any misallocation has no impact on prices. Second, the lobbying audit preceded the no-sharing price cap regulation. Third, the same analysis would have been required irrespective of whether a carrier was under Class A or Class B accounting; just as lobbying activity was only one type of activity contained in the Class A Account 7370, it would be only one type of activity contained in the Class B Account 7300, with the examination of underlying records required in either case.

---

[17] See Notice at ¶7.

[18] See Notice at Footnote 19.

III. ALL CARRIERS SHOULD BE ALLOWED TO SUBMIT THEIR COST ALLOCATION MANUAL (CAM) AT THE CLASS B LEVEL AND OBTAIN AUDITS EVERY TWO YEARS INSTEAD OF ANNUALLY.

The Notice proposes to modify some of the CAM requirements for mid-sized LECs because of the lower transactional volumes for mid-sized versus large incumbent LECs. As a result, it is proposed that mid-sized LECs may submit their CAMs at the Class B level, thereby reducing the administrative burden of the nonregulated activity matrix and the cost apportionment tables. Mid-sized LECs would also perform an attest CAM audit every two years instead of an annual positive opinion CAM audit.[19] These changes are not proposed for the large incumbent LECs. As with the accounting proposals, the Notice justifies retaining current requirements for large LECs because of the Commission's monitoring and oversight responsibilities, and their greater transactional volume and the risk of cross-subsidy.

As with the justification for the continued application of Class A accounting for only the large incumbent LECs, the Commission's justification does not withstand scrutiny. A comparison of the dollar value of affiliate transactions to total operations of the mid-sized and large LECs does not support the contention in the Notice of greater transactional volume.[20] The risk of cross-subsidy is no greater for the large LECs and arguably is less given that the large LECs are under no-sharing price caps.

In the Accounting Safeguards proceeding, the Commission raised the threshold question of the continued application of the cost allocation requirements, and concluded that such requirements continued to be necessary because the interim price cap rules permitted carriers to

---

[19] See Notice at ¶¶10 and 11.

[20] See Table 1 *supra.*

select the productivity factor, two of which included a sharing provision. The interstate price cap rules also permitted a low end adjustment formula. Some states may also be subject to rate of return regulation providing an incentive to cross-subsidize.[21] These justifications are no longer sound and the Notice provides no new justification. Carriers are no longer subject to a sharing provision.[22] As the Arthur Andersen Paper shows, the low end adjustment formula is rarely used and does not, in itself, support the continued application of the cost allocation requirements.[23] Additionally, most states are no longer on rate of return regulation. With respect to Section 254(k) requirements, the Accounting Safeguards Order concluded that the requirements would be addressed in another order. As previously discussed, the order on Universal Service concluded that forward looking economic costs would be used and not historical embedded costs.[24]

The Notice provides no justification for the continued application of the cost allocation requirements. At a minimum, all carriers should be allowed to use Class B cost allocations and obtain audits every two years instead of annually.

---

[21] See *In the Matter of Implementation of the Telecommunications Act of 1996: Accounting Safeguards Under the Telecommunications Act of 1996*, CC Docket No. 96-150, Report and Order, released December 24, 1996 at paragraph 271.

[22] See, *In the Matter of Price Cap Performance Review for Local Exchange Carriers,* CC Docket No. 94-1, Access Charge Reform, CC Docket No. 96-262, Fourth Report and Order in CC Docket No. 94-1 and Second Report and Order in CC Docket No. 96-262, released May 21, 1997, at paragraph 144. See, also Affidavit of J. Gregory Sidak in USTA Comments filed May 31, 1996 In Allocation of Costs Associated with Local Exchange Carrier Provision of Video Programming Services, CC Docket No. 96-112. Mr. Sidak concludes that the Commission should forbear from regulation the Part 64 cost allocation rules for carriers under incentive regulation with no sharing provision.

[23] See Arthur Andersen Paper at footnote 14.

[24] See footnote 13 *supra.*

IV. THE PROPOSED REDUCTION/ELIMINATION OF ACCOUNTS ON FILING REQUIREMENTS SHOULD BE ADOPTED, ALONG WITH A MUCH MORE SWEEPING PROPOSAL CONTAINED IN THE ARTHUR ANDERSEN PAPER.

While Ameritech supports the accounting changes proposed in the Notice, they are, wholly inadequate in scope. The Notice proposes the consolidation of Accounts 2114, 2115, and 2116, and Accounts 6114, 6115, and 6116, into Account 2114, Tools and other work equipment, and Account 6114, Tools and other work equipment expense, respectively.[25] It also proposes to amend Section 32.23(c) and Account 5280, Nonregulated operating revenues, to enable carriers to record all nonregulated revenue in Account 5280[26] and Section 32.16, Changes in Accounting Standards, to provide only a current year revenue requirement study instead of three years.[27] Finally, the Notice proposes to eliminate the requirement of Section 32.2000(b), Telecommunications Plant Acquired, for the submission of journal entries associated with acquisitions.[28]

Ameritech proposes that the accounting proposals contained in the Arthur Andersen Paper be adopted by the Commission now. An interim, albeit less compelling option, is for the Commission to retain the Class A account structure for the large incumbent LECs, but to eliminate certain sections that are no longer relevant for no-sharing price cap companies. This can be readily accomplished with the addition of the following new section 32.2(g) and cross

[25] See Notice at ¶¶14-15.

[26] See Notice at ¶16.

[27] See Notice at ¶17.

[28] See Notice at ¶18.

referenced in identified sections of Part 32:

> 32.2(g) LOCAL EXCHANGE CARRIERS UNDER PRICE CAP REGULATIONS WITHOUT SHARING, PURSUANT TO SECTION 61.41(a)(2) & (3) OF THE COMMISSION'S S RULES, SHALL NOT BE SUBJECT TO THOSE SECTIONS OF PART 32 SO IDENTIFIED. RATHER, GENERALLY ACCEPTED ACCOUNTING PRINCIPLES SHALL APPLY.

This proposal was outlined in the Ameritech Accounting Reform Proposal, and results in the elimination of unnecessary detail, notification requirements, and constraints, while maintaining the Class A level of account detail. [29] Included as Attachment 3 is a detailed annotated revised Part 32, including revisions to Section 32.27 adopting a $1 M materiality threshold for conducting fair market value studies and expanding the exemption for use of fully distributed cost to support services provided to affiliates.

V. CONCLUSION.

The proposals in the Notice fall far short of the mark in the Act's requirement to review all of its regulations and modify or eliminate any regulation no longer in the public interest. The Arthur Andersen Paper provides a blueprint for change that is consistent with the deregulatory, pro-competitive market that the Act was designed to achieve. Their proposals should be adopted

[29] See footnote 6 *supra*.

now. In the alternative, Ameritech's proposals retaining the Class A account structure but eliminating unnecessary constraints, notification requirements, and detail should be adopted only for a short interim and as the bare minimum necessary under the Act.

Respectfully submitted,

Leander R. Valent
Counsel for Ameritech
9525 West Bryn Mawr, Suite 600
Rosemont, IL 60018
(847) 928-4396

Dated: July 17, 1998

ACCOUNTING SIMPLIFICATION IN THE TELECOMMUNICATIONS INDUSTRY

Prepared by Arthur Andersen LLP

July 15, 1998

ARTHUR ANDERSEN

ACCOUNTING SIMPLIFICATION
IN THE TELECOMMUNICATIONS INDUSTRY

Prepared by Arthur Andersen LLP

TABLE OF CONTENTS

ACCOUNTING SIMPLIFICATION
IN THE TELECOMMUNICATIONS INDUSTRY

Prepared by Arthur Andersen LLP

I. INTRODUCTION

Arthur Andersen LLP ("Arthur Andersen")[1] was engaged to prepare this position paper entitled "Accounting Simplification in the Telecommunications Industry" by a coalition of local exchange carriers ("LECs") including Ameritech Corporation, BellSouth Corporation, GTE Service Corporation, SBC Communications Inc. and U S WEST, Inc. ("the LEC Coalition"). This paper will analyze the Federal Communications Commission's ("FCC" or "Commission") Uniform System of Accounts ("USOA") for Telecommunications Companies contained in Part 32 of the FCC's Rules and Regulations and identify and recommend opportunities for simplification and streamlining. These simplification opportunities should be adopted in order to further the industry's move to a competitive, deregulated environment. This will help eliminate unnecessary constraints of USOA rules and regulations where competing classes of service providers are not bound by such requirements.

The overall conclusion of Arthur Andersen is that the USOA does not reflect the existing regulatory and competitive paradigm. Rather, the USOA has evolved into a regulatory reporting system solely to meet regulatory reporting requirements. As such, the USOA imposes an unnecessary and costly constraint on the carriers subject to its requirements. Such requirements should be streamlined and/or eliminated in order to provide subject carriers the increased flexibility necessary in today's competitive environment and to move the LEC industry towards accounting and recordkeeping "best practices" utilized by their competitors and companies outside of the local exchange telecommunications industry.

The accounting rules embodied in Part 32 (in particular the level of accounting and recordkeeping specificity required) were developed principally to support rate of return regulation in the absence of competition. As all LEC Coalition members and many other large LECs have adopted price cap regulation without earnings sharing in the interstate jurisdiction (and in the majority of state jurisdictions), and as increased competition is the overall goal of the Telecommunications Act of 1996 (the "Telecommunications Act"), those accounting and recordkeeping requirements designed in support of traditional rate of return regulation are no longer necessary.

The USOA imposes significant recordkeeping requirements on subject carriers that bring with them significant costs of compliance. The continuing benefits associated with many of these requirements are unclear, given the current regulatory and competitive paradigm. Further, competitors to the LECs are not subject to the same USOA

---

[1] Arthur Andersen is a global multi-disciplinary professional service firm that helps its clients improve their business performance through assurance and business advisory services, business consulting, economic and financial consulting, and tax, legal and business advisory services. With more than $5 billion in revenues, and 58,000 employees, Arthur Andersen serves clients in more than 363 locations in 78 countries.

requirements but must comply with only generally accepted accounting principles ("GAAP"). These "costs of regulation" are very real and must be considered in today's competitive environment.

As described in Section 32.1 of Part 32, "The [revised] USOA is a historical financial accounting system which reports the results of operational and financial events in a manner which enables both management and regulators to assess these results within a specified accounting period. The USOA also provides the financial community and others with financial performance results. In order for an accounting system to fulfill these purposes, it must exhibit consistency and stability in financial reporting (including the results published for regulatory purposes). Accordingly, the USOA has been designed to reflect stable, recurring financial data based to the extent regulatory considerations permit upon the consistency of the well established body of accounting theories and principles commonly referred to as generally accepted accounting principles."[2] The Part 32 Rules became effective on January 1, 1988, replacing the prior Parts 31 and 33 as the new accounting system.

A careful analysis of the above Part 32 "mission statement" reveals that, in today's industry environment, the USOA fails to accomplish many of the objectives stated above. For example:

- Management no longer utilizes USOA results to manage the business – in particular, the expenses as categorized under Part 32 do not present a clear picture of activities performed to produce a product or service. Thus, companies have designed management information systems that focus on activity-based cost information (e.g., salaries and wages, by activity or service, versus buried cable expense).

- The financial community for the most part no longer uses the financial results derived pursuant to Part 32. Each of the LEC Coalition members as well as several other LECs have discontinued the application of Statement of Financial Accounting Standards ("SFAS") No. 71, "Accounting for the Effects of Certain Types of Regulation," in producing their audited financial statements that are filed with the Securities and Exchange Commission ("SEC") and published to the financial community. Additionally, these published statements are a better reflection of the LECs' actuals economic environment and performance than statements derived pursuant to Part 32.

- The stability of the USOA should also be closely looked at. In light of the tremendous changes in the industry since its adoption in 1988, in many respects the USOA's stability has rendered it obsolete as an accounting system intended to reflect the current results of operations of subject carriers in a consistent and relevant manner.

[2] 47 CFR §32.1

ACCOUNTING SIMPLIFICATION IN THE TELECOMMUNICATIONS INDUSTRY

Prepared by Arthur Andersen LLP

Arthur Andersen recommends that the FCC carefully review the continued applicability of the Part 32 USOA and its detailed accounting and recordkeeping requirements for **all** carriers, not just those falling beneath an arbitrary threshold. Arthur Andersen demonstrates that the simplification proposals discussed in this paper provide for such a transition from today's detailed Part 32 regulatory accounting and recordkeeping requirements to more of a "level playing field" where all carriers are subject to the same requirements under GAAP. These recommendations can be adopted now to ease the accounting and recordkeeping requirements on **all** LECs with the ultimate goal being full reliance on GAAP.

ACCOUNTING SIMPLIFICATION
IN THE TELECOMMUNICATIONS INDUSTRY

Prepared by Arthur Andersen LLP

II. SUMMARY RECOMMENDATIONS

Arthur Andersen developed this paper via extensive discussions with and surveys of LEC Coalition members and review of FCC and state public utility commission orders, relevant legislation including the Telecommunications Act and other regulatory filings. Surveys of companies outside the telecommunications industry were also conducted with the purpose of identifying "best practices" information in the areas of accounting and recordkeeping. This research was directed at identifying areas within Part 32 that are overly detailed and/or complex as compared to the corresponding requirements and practices in other industries.

The areas with the greatest opportunity for simplification and/or elimination are as follows:

- Part 32 Account Structure and Accounting Requirements
- Property Records and Depreciation Requirements
- Affiliate Transaction Rules

Simplification opportunities in the above areas are discussed in detail in Sections IV., V. and VI. of this paper, respectively. In addition to the above areas, we assess the future role of regulatory oversight in light of the significant changes in the industry environment and the proposed changes discussed in this paper. The following summarizes each of these sections.

Part 32 Account Structure and Accounting Requirements

The Part 32 accounting structure is overly detailed and in many cases exceeds the accounting requirements of GAAP. The Part 32 account structure further does not facilitate management or external reporting and is used only for regulatory reporting in the current environment contrary to the original intent of the USOA. Charts of accounts in other industries are more closely aligned with the external reporting requirements and management information needs of the business. While management information is most often the underlying basis of such accounting systems, GAAP reporting standards must also be adhered to without exception.

In the long-term, GAAP should be relied on in the telecommunications industry with minimum regulatory intervention. The FCC can take the following steps now, however, to eliminate/streamline certain detailed requirements and provide a roadmap for the LECs to transition to full GAAP reliance:

- Reduce current level of accounting detail for all carriers:
  - Rely on Class B level of reporting and eliminate Class A main account detail
  - Reduce or eliminate the subsidiary record categories for various cost types

- Eliminate expense matrix categorization requirements.

- Rely on GAAP principles of materiality in regards to capitalization policy rather than using the expense limits for telecommunications plant and general support assets prescribed in Part 32.

- Rely on GAAP principles of materiality rather than the current standards prescribed in the USOA.

- Rely on GAAP standards in lieu of the current USOA advance notification requirements related to:
  - Adoption of new accounting standards.
  - Recognition of extraordinary items, prior period adjustments and contingencies.

Property Records and Depreciation Requirements

The Part 32 requirements with respect to telecommunications plant accounting and recordkeeping are significantly more detailed than what GAAP requires and should be eliminated or at a minimum significantly reduced. The level of detail at which accounts, subaccounts and detailed plant record categories are defined far exceed the recordkeeping necessary to verify the existence of plant assets and support the asset balances presented in the financial statements. To the extent that technology and/or the needs of the business change, corresponding changes in the way in which assets are managed and accounted for should also be made without regulatory delay.

The FCC can take the following steps today to streamline property accounting and depreciation requirements and provide a roadmap for the LECs to transition to full GAAP reliance:

- Reduce the recordkeeping requirements and redefine property units to allow for the accounting and tracking of telecommunications plant assets at the level of detail used by management to run its business and manage its assets.
  - Eliminate notification requirements with respect to basic property record ("BPR") plan changes
  - Eliminate detailed plant subaccounts/subsidiary record categories which exceed GAAP and asset management requirements
  - Allow for the tracking of assets on an average cost, instead of original cost, basis
  - Reduce requirements for asset tracking - continue to require asset tracking by general location (address)

- Allow carriers to set depreciation rates and methods based on economic analyses in place of the current depreciation represcription and rate setting processes.

- Rely on GAAP principles of materiality to dictate the use of expense limits rather than mandating specific limits in the USOA.

- Allow for increased flexibility (within GAAP criteria) in the determination of depreciation expense. Carriers should be able to use depreciation methods that most closely reflect the use (and decline in net realizable value) of assets. Methods such as vintage amortization life ("VAL") for non-network and immaterial network assets, that reduce the ongoing costs of asset tracking and accounting, should also be allowed.

Affiliate Transaction Rules

The affiliate transaction rules contained in Section 32.27 of the USOA are unduly complex and require carriers to incur significant costs in order to comply with such rules. In 1997, these requirements were increased, rather than streamlined, adding to the cost and complexity associated with these rules.[3] While relevant in the traditional rate of return regulation environment, the Section 32.27 rules (and related cross-subsidy concerns) are clearly less relevant under price cap regulation.

In the long-term, GAAP should be relied on in this area with minimum regulatory intervention. In the near-term, however, the following affiliate transaction requirements can be revised, simplified or eliminated:

- Eliminate the asymmetrical affiliate transaction rules with respect to the provision of services between regulated and nonregulated affiliates.

- Eliminate the application of the 50% threshold on a product-by-product and service-by-service basis, for determining the existence of a "substantial" third party market and the validity of using prevailing market prices for affiliate transactions.

- Implement a materiality-based and/or rotational requirement for performing fair market value studies in order to limit the costs of compliance.

- Expand the exemption provided in paragraph 148 of the Accounting Safeguards Order (that allows nonregulated affiliates of the LEC that *exist solely* to provide services to members of the affiliated group to price such services at cost) to:
  - Support services provided *to* affiliates that exist solely to provide services within the affiliated group
  - Specific product/service lines offered only to affiliates

[3] *Accounting Safeguards Under the Telecommunications Act of 1996*, Report and Order, CC Docket No. 96-150, FCC 96-490 (rel. December 24, 1996), [hereinafter Accounting Safeguards Order].

ACCOUNTING SIMPLIFICATION IN THE TELECOMMUNICATIONS INDUSTRY

Prepared by Arthur Andersen LLP

Future Role of Regulatory Oversight

If the above changes are implemented as suggested, the role of the Federal and State regulators would most certainly change. Instead of auditing the LECs' strict compliance with detailed USOA accounting and recordkeeping requirements, regulators would shift their emphasis to more relevant business risks and issues faced by the carriers. Instead of focusing on historical regulatory compliance activities, regulators should become more proactive, facilitating the implementation of the Telecommunications Act by instituting less regulation rather than more. Compliance with the accounting and recordkeeping requirements can be more focused under a simplified USOA - instead of culling through a mass of detailed accounting data, regulators should only to the extent necessary:

- Review accounting information prepared on a GAAP basis and benchmark such data against companies operating in similar industries.
- Request accounting information on a focused, issue-driven basis.
- Review the same data that is reported to the financial community and avoid reconciliation of regulatory accounting information with externally reported financial information.
- Increase the flexibility of audit and other compliance efforts (i.e., not be bound to performing detailed compliance audits to verify the accuracy of over-detailed information just because it is reported to the Commission).

Each of the above areas for potential Part 32 simplification is explored in depth in the attached paper. The paper assesses the background of relevant USOA accounting and recordkeeping requirements and the current industry environment which is driving the need for change, compares USOA accounting and recordkeeping requirements with other industry "best practices" and provides recommendations for simplification and/or elimination of USOA requirements that can be adopted immediately transitioning to full GAAP reliance.